The purpose of the conceptual framework essays example

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Addressing the key issues of financial reporting such as (IFRS foundation, 2011, p. A17) including the objectives of the financial reporting and qualitative characteristics which make the financial statements useful, the Conceptual Framework was initially adopted by IASB in 1989 and subsequently updated in 2010 through a joint project with FASB. As stated in the IASB's Conceptual Framework, its primary purposes include (IFRS Foundation, 2011, p. A16) providing theoretical underpinnings to IASB in setting future standards as well as in review of existing ones and promoting harmonization of accounting standards through eliminating alternative treatments currently allowed.

The importance of having a theoretical basis underpinning accounting standards is best understood by putting it in historical and political context. Historically, national accounting standards have been developed by reference to the best existing practices and one of their major purposes was to protect the accounting practitioners against litigation (Elliott & Elliott, 2009, p. 158). However, given the lack of encompassing accounting theory, the standard setting process in the US and elsewhere was deemed rather chaotic, arising out of practice. It was eventually taken on by standard setting bodies, such as FASB (Belkaoui, 2005, p. 153). The standards setters have put in place conceptual frameworks (Alexander, Britton & Jorissen, 2011, p. 133), which guided the standard setting process, helping them to create standards in a coherent manner with observance of due processes and not on an ad hoc basis.

Another concern regarding standard setting is the pressures from the environment. It is long acknowledged that financial reporting is affected by economic, political, legal and other factors (Belkaoui, 2005, p. 183). In this regard the standing of standard setting bodies and their resilience to possible pressures from the special interest groups is important. As noted by the SEC in its evaluation of a convergence project between US GAAP and IFRS, IFRS Foundation is ‘ a private not-for-profit organization and ultimately has no ability to require or compel funding’ (SEC, 2012, p. 6). Its funding reliance on the big accounting firms is a major concern for the SEC as well as for the public at large. Taking into account this public concern, existence of a sound framework guiding the standard setter could serve as a possible safeguard of IASB against undue influence. To what extent the Conceptual Framework has solved these problems is debatable. While a significant progress over the last decade has been made towards harmonizing IFRS there are instances showing that IASB is vulnerable to market and political pressures. E. g. during the recent financial crisis that started in 2008 IASB allowed reclassification of assets measured at fair value to a portfolio measured at amortized cost. That change in the standard made under the political pressure was carried out without observing due process and led to the significant criticism of IASB (Elliott & Elliott, 2009, p. 319).

Joint project of IASB/FASB on the Conceptual Framework

The joint conceptual framework project was part of the broader convergence project between IASB and FASB. While an important milestones - objectives and qualitative characteristics of the financial reporting – have been achieved, the rest of the project has been effectively suspended (IASB, 2010).

As regards EU adoption, it is evident that EU is a unique case, being comprised of 28 nation states without a clear leader state. In order to create the single economic and capital market, it was necessary to adopt a single set of standards.

Going further, research on post IFRS adoption (e. g. Heidhues and Patel, 2012, Richard, Besadon & Collette, 2014) has raised issues related to de facto IFRS adoption related mainly in the cultural and legal milieu of countries, which might have values and incentives constraining implementation of IFRS.

Coming back to the US, it is the leading world capital market, with the established institutions, and financial reporting systems. Apparently, at this stage the advantages of IFRS adoption are not as attractive as to persuade SEC to abandon or significantly change the existing infrastructure that works successfully (. Therefore, one could argue for the advantages of principles based standards (IFRS) over rule based ones (US GAAP), however, given the litigious nature of the US and its existing institutional norms, a more detailed guidance could be warranted. Another impeding factor is that there are over one million accountants in the US (Belkaoui, 2005). Re-learning of such a mass of accountants is both costly and time consuming.

Making a comment that IFRS is still to be improved in order to be acceptable for SEC the Chairman Schapiro (Schapiro, 2012) signaled that SEC is leaning towards gradual convergence without a committing to a certain deadline. As the adoption of IFRS in the US is off the table for the foreseeable future, it is only logical that both Boards have shifted their attention away from this project.

Reliability in the new Conceptual Framework

The other important purpose of the Conceptual Framework is to define qualitative characteristics and set direction for future developments (McGregor and Street, 2007, p 49). Historically reliability has been one of the cornerstones of accounting. However, the revised Conceptual Framework IASB has undergone considerable change in this respect and identifies relevance and faithful presentation (Zhang, 2011, p. 12). An accounting debate over trade off between relevance and reliability has a long history (Laux and Leuz, 2009, p. 826). Some information may be important for decision making (e. g. estimate of unobservable price or value, IFRS Foundation, 2011a), however may be not free from error. In terms of accounting measurement techniques, fair value measurement appears to be more relevant, but less reliable, as it often relies on the usage of complicated models. At the other end of the spectrum is the historical cost, which is very reliable, however, may be less relevant for the decision making. In a detailed review of the changes taken place in the updated Conceptual Framework, Zhang (2011, p. 12) argues that IASB leaned towards giving more value to the concept of relevance, while reliability has been replaced with faithful representation, due to the term’s perceived lack of clarity. Zhang (2011, p. 13) and Cairns (2010) further argue that these changes underpin the IASB’s agenda to promote fair value accounting which is perceived as an effective free market mechanism. Though, the latest developments are contrary to the historical conservatism of accounting profession, one can understand why IASB favors such an approach – it is justified by the complexity of the modern economy, increased mobility of capital and the need of investors for relevant information.

Proposed treatment of reliability in the Conceptual Framework

As discussed above, until recently reliability was one of the pillars of accounting. It is clear that standard setters always face a difficult tradeoff between reliability and relevance (Laux & Leuz, 2009, p. 831). This trend of the increasing importance of relevance, perhaps at the expense of reliability leads to more extensive usage of technically complicated standards on financial instruments and fair value requiring more professional judgment on the part of accounting profession.

However, one important aspect which is not to be overlooked is the information asymmetry between the financial report preparers (management) on one hand and the investors and regulators on the other hand. If too much judgment and flexibility is allowed by the standards, then reporting can be gamed with by unethical managers. However, too rigid standards will lead to reporting information which may be irrelevant, or in worse case, misleading for the decision making.

Another important point in this discussion is that ability to exercise professional judgment is influenced by culture (Belkaoui, 2005, p. 379). The problem is that IFRS serving many countries with very different cultures has become the proverbial ‘ one size fitting all’.

No surprise that there is a notable criticism of attaching less importance to the reliability in more conservative environments such as Germany and France (Heidhuis & Patel, 2012, p. 29).

As IFRS Foundation (2011) puts it, the reliability concept has been removed due to a ‘ lack of common understanding’.

However, the preferred treatment is to re-instate it in the IFRS with a more clear definition. This would alleviate concerns of more conservative part of accounting profession. The revised Conceptual Framework has sought to lay solid foundation under the IFRS to guide standard setting. However, some problems and inconsistencies in standard setting process still persist. It is also more likely that the accounting world will remain multi-polar, at least in the short to medium future, with the major centers except the EU still not embracing IFRS. The sophistication of economic environment leads to more complex and technical standards requiring more judgment on the part of accountants at the expense of reliability.

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